



North Carolina General Assembly

Legislative Services Office
Legislative Office Building
300 N. Salisbury Street, Raleigh, N. C. 27603-5925

Exhibit D

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GEORGE R. HALL, JR., Legislative Administrative Officer
(919) 733-7044

M. GLENN NEWKIRK, Director
Automated Systems Division
Suite 400, (919) 733-5334

GERRY F. COHEN, Director
Bill Drafting Division
Suite 100, (919) 733-6660

THOMAS L. COVINGTON, Director
Fiscal Research Division
Suite 619, (919) 733-4910

TERRENCE D. SULLIVAN, Director
Research Division
Suite 545, (919) 733-2578

February 20, 1992

MEMORANDUM

TO: Joint Select Legislative Committee
on State Health Insurance

FROM: Sam Byrd
Fiscal Research Division *Sam*

SUBJECT: Fiscal Concerns for the
State Employee Health Benefit Plan

At your last meeting on January 29, 1992, we informed you that we were beginning to see concrete evidence of adverse selection against the basic self-insured program of benefits within the Plan. We also agreed to provide you this evidence at your next scheduled February 26, 1992, meeting after having reviewed both the basic self-insured program's enrollments and alternative prepaid program enrollments in health maintenance organizations (HMOs) through December 31, 1991. This memorandum intends to give you this evidence.

The governing part of benefits within the Plan is the basic self-insured program, which determines premiums paid to competing HMOs. During the summer of 1986, the Plan, for the first time, offered employees, retirees, and their dependents the option of enrolling in HMOs as opposed to enrolling in the basic self-insured program, which had been in existence for about four years. Obviously, adverse selection against the basic program by HMOs selectively enrolling the better risks leaving the worst risk to the self-insured program was of prime concern to the Legislative Committee on Employee Hospital and Medical Benefits. Consequently, G.S. 135-39.5B was amended to authorize the Plan's Executive Administrator and Board of Trustees to assess and collect risk management fees from the HMOs. An example of how such fees are determined is illustrated by the following per capita claim costs for the basic self-insured program based upon the age of those covered by the program:



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<u>Beneficiary Age</u>	<u>1990-91 Per Capita Claim Costs</u>
0-29	\$ 666
30-44	1,136
45-54	1,470
55-64	2,329
65+	1,049

Against these claim costs are applied non-age rated premium amounts adjusted only for Medicare "carve-out" eligibility. An example of adverse selection in this instance would be the self-insured program's loss of beneficiaries under age 30, a gain in beneficiaries age 55 to 65, while losing the same amount of per capita premiums for each age group. The same type of affects are felt by the self-insured program whenever gains in the number of non-Medicare retirees and their dependents are realized especially when a loss in the number of active employees and their dependents occurs simultaneously. The risk management fees charged to HMOs account for net losses to the self-insured program from these occurrences. Currently, the risk management fees are:

<u>HMO Enrollee's Age</u>	<u>Per Capita Monthly Risk Management Fee</u>
0- 4	\$ - 0 -
5-19	12.00
20-29	8.00
30-39	6.00
40-49	4.00
50+	- 0 -

For the 1990-91 fiscal year, we expect adverse selection against the basic self-insured program to be some \$2.5-\$3.0 million from some 50,200 members enrolled in HMOs. In comparison, HMOs are expected to remit to the Plan some \$3.0 million in risk management fees for these 50,200 members.

However, of greater concern to us at this point, are the effects of last October's premium rate increase in the self-insured program upon the dependents of employees and retirees. These rate increases were:

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<u>Premium Rates</u>	<u>Monthly Premiums Paid by:</u>		
	<u>Employer</u>	<u>Employee</u>	<u>Total</u>
<u>Non-Medicare</u>			
Employee & Child(ren)	\$144.60	\$90.12	\$234.72
\$ Increase	\$36.70	\$24.82	\$61.52
% Increase	34%	38%	36%
Employee & Family	\$144.60	\$216.18	\$360.78
\$ Increase	\$36.70	\$63.94	\$100.64
% Increase	34%	42%	39%
<u>Medicare</u>			
Employee & Child(ren)	\$110.08	\$68.50	\$178.58
\$ Increase	\$27.94	\$18.86	\$46.80
% Increase	34%	38%	36%
Employee & Family	\$110.08	\$164.30	\$274.38
\$ Increase	\$27.94	\$48.60	\$76.54
% Increase	34%	42%	39%

As a result of both these premium rate increases and HMO enrollments, the basic self-insured program experienced the following between December 31, 1990 and December 31, 1991:

- (a) A net loss of 8,487 active employees; 10,404 to HMOs; 1,917 gain from new hires
- (b) A net gain in retired employees of 2,174
- (c) A net loss of 14,023 active employee dependents; 8,665 to HMOs; 5,358 to dropped coverage
- (d) A net loss of 4,707 active employee family contracts; 1,665 to HMOs; 3,042 to dropped coverage

Of these losses in the number of active employee dependents, 72% of the losses were from dependents under age 30 and 20% were from dependents age 30 to 45.

As you can see from all of the foregoing statistics, adverse selection against the basic self-insured program is at a critical stage in our opinion. Loss of favorable risks to HMOs are being compensated through risk management fees assessed the HMOs. Dropped dependent coverages for favorable risks are not however being compensated. To further substantiate these conclusions, we would offer the following underwriting statistics for the self-insured program for the six-month period ending December 31, 1991:

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	<u>Active</u>	<u>Dependents</u> <u>Retired</u>	<u>Total</u>
Est. Premium Receipts - Net (Million)	\$53.523	\$11.271	\$64.794
Actual Claim Cost - Gross (Million)	\$71.129	\$9.630	\$80.759
Premiums Over (Under) Claim Costs (Million)	\$(17.606)	\$1.641	(\$15.965)
Rate of Premiums to Claims	\$0.75:\$1.00	\$1.17:\$1.00	\$0.80:\$1.00
Average Number of Enrollees	134,791	14,404	149,195

As stated previously in this memorandum, our purpose is to provide you evidence of greater adverse selection in the basic self-insured program. Our conclusion is to urge you to fully consider the affects of further premium rate increases upon the program's current adversely-selected fiscal experience. If premiums are again increased for dependents during this biennium, such will be a first in the self-insured program's ten-year existence.

SB:ap



ADMINISTRATIVE OFFICE OF THE COURTS

JUSTICE BUILDING

P. O. BOX 2448

RALEIGH, NORTH CAROLINA 27602

FRANKLIN FREEMAN
DIRECTOR

DALLAS CAMERON
ASSISTANT DIRECTOR

November 19, 1992

Mr. Curtis Clark
Director
Government Performance Audit Committee
Room 612
Legislative Office Building
300 North Salisbury Street
Raleigh, North Carolina 27603-5925

Dear Curtis:

Enclosed, please find the Administrative Office of the Courts response to the Phase I Performance Audit of the Personnel System and the analysis of the Information Services Division of the AOC.

On behalf of Chief Justice James Exum and the North Carolina Judicial Branch of Government, I appreciate the opportunity to respond to these portions of the Performance Audit, and I appreciate your indulgence with my tardiness. Because of the importance to the judiciary of the issues raised in the Personnel audit, I particularly wanted a thorough review of our response. That required me to circulate a draft to selected judges, district attorneys, and clerks of court throughout the State.

If these matters are scheduled for presentation to the committee or if I can provide further information or be of further assistance, please call me.

With warm personal regards,

Sincerely,

A handwritten signature in cursive script that reads "Franklin".

Franklin Freeman

cc: Chief Justice James Exum, Jr.
Chris Marks
Ivan Hill
Fran Taillefer

**Administrative Office of the Courts
Response to the Phase I Performance Audit
of Information Technology Systems
as it Concerns the Information Services Division
of the Administrative Office of the Courts**

The audit findings and recommendations included in the Government Performance Audit Committee (GPAC) draft audit report with respect to the Information Services Division within the Administrative Office of the Courts (AOC) are accurate and reflect valid concerns that we also share.

We appreciate the GPAC's recognition of the efforts made by the AOC to comply with the State Auditor's recommendations. Even so, the GPAC report notes that some recommendations of the State Auditor remain to be implemented. The AOC concurs that it is desirable to fully implement all the recommendations, and we remain committed to that goal.

Achievement of our goal for full implementation of these recommendations has been elongated due to the limited amount of personnel we have available for this task. As part of our FY 1993-95 Expansion Budget request, we will be seeking legislative funding support for personnel to address the areas of disaster recovery, capacity and performance management, and business emergency planning. In the mean time, we will, within available resources, continue our efforts toward full compliance with the State Auditor's recommendations.

Response of
Administrative Office of the Courts
to Selected Findings of Phase I
Performance Audit of the Personnel System

Experience-based Compensation System for Judicial Officials

Consider the following scenarios which are likely to occur daily in the courts of North Carolina:

The victim's family is crying. The defendant is staring, stone-faced. The district attorney is arguing with the defendant's lawyer about whether a critical piece of evidence is to be admitted. It is a close case, one for which there is not established precedent, and the ruling will in effect determine the case. Who makes the call? A judge of the superior court. The evidence is admitted, the defendant is convicted and the jury finds the death penalty is justified. Who has to look the defendant in the eye and tell him he will be put to death? The same judge of the superior court.

A prominent governmental official is suspected of taking a bribe. He has many friends who believe he is being harassed. Many other citizens believe a cover-up is in the making. Who decides if the prosecution should continue or be dismissed? A district attorney.

Two brothers are each trying to become the guardian of the estate of their incompetent sister. The estate has the controlling shares in a multi-million dollar family business. The business provides most of the jobs in the small town in which they live. Who decides who will be the guardian, and thus who will control the business? The clerk of superior court.

A family of four is splitting up. The father and mother have irreconcilable differences. The children want to live with the father, but the mother fears that the father's lifestyle will not provide the guidance the children need. Who decides where these children will call home? A district court judge.

These are typical of the kind of decisions elected judicial department officials make every day. The most intractable social, business and personal problems in our society all find their way into our courtrooms. It is one of the characteristics of a democracy that its citizens place the full power of the state in the hands of some of their fellow citizens and ask them to use it wisely in passing judgment on others. It is one of its strengths that they do. It is a daunting task, and one in which wrong judgments can haunt a person for the rest of his or her

life. It is also a job done in a fishbowl - in public for everyone to see, evaluate and criticize.

To tighten the pressure valve a little tighter, all these officials also regularly face an evaluation of their work in the most public of settings - the ballot box.

The decisions these officials make affect the lives of people permanently. There is no course one can take to prepare for these kinds of decisions. The best course is experience.

The practice of paying more for people with on-the-job (or equivalent) experience recognizes the value of that experience. That has been North Carolina's policy. There is no reason to change it now.

Elected officials in the judicial branch, as well as a few key appointed officials, are paid a base salary, set by the General Assembly. They then receive at each succeeding five year interval (until they reach 20 years), an increase in compensation of 4.8% of their base pay. This longevity pay is applicable to judges, clerks, district attorneys and their assistants, public defenders and their assistants, and the Director and Assistant Director of the Administrative Office of the Courts. Under the controlling statutes, it is "[i]n lieu of merit and other increment raises paid to regular State employees". It is the sole method for encouraging experienced elected and other highly important judicial officials to remain on the job through pay increases earmarked at those most needed by the system.

By statute, the rate paid is higher than that paid for "regular State employees" and it begins to be paid after five years instead of the ten year minimum for "regular State employees".

The draft report prepared for the Government Performance Audit Committee recommends that this "longevity pay" be eliminated for judicial officials. That recommendation is based on two assumptions: That the money used for longevity pay should be shifted to provide raises based on performance, and that it is unequal to provide judicial officials with longevity pay at rates greater than those provided to "regular state employees".

To understand why this recommendation should be reconsidered, it is helpful to contrast the fairly simple system for compensating elected judicial officials with the compensation system for "regular State employees". That system has salary grades, merit increments, and longevity pay. Longevity pay is a small part of the compensation system for these state employees. Of far more importance is the prospect of job reclassifications, promotion to another

position, and step increases in the grade. Longevity pay's relative importance is evidenced by the method of payment - a lump sum paid once a year. It is hard to rely on that kind of payment in constructing a monthly budget. Finally, "regular State employees" have the benefit of job security under the State Personnel Act.

The recommendation has the apparent appeal of treating everyone equally. But it doesn't do that. To do that, judges, other elected officials and key appointees would have to be given the job security equivalent to that in the State Personnel Act. They would also have to be evaluated by someone with power to give them performance-based raises. Neither is traditional nor appropriate for these officials.

An elected official is answerable to the electorate; it is not a very secure employment arrangement. The appointed officials covered by this compensation system have no greater job security; they either are appointed directly by an elected official for fairly short terms of office or serve at the pleasure of one. North Carolina has wisely stayed away from having one elected (or even worse, a non-elected) official determine pay raises for other elected officials. That is the job of the General Assembly, speaking as a body. To do otherwise would seriously impair the independence of the judiciary; that is in part why it is elected in the first place. It would also fail to recognize the inherent difficulty in evaluating one whose mission is to do justice by using traditional measures of productivity. The one venture in this arena (merit pay for elected clerks, in the discretion of the Administrative Officer of the Courts) was abandoned as unworkable and inappropriate for elected officials shortly after its implementation in the 1970's.

If performance pay is inconsistent with judicial office, then the virtue of the current system of encouraging experienced officials to remain on the job through increments becomes clear. It provides an incentive without impairing the independence necessary to do the job.

The current system also compensates for the other opportunities for compensation increases available to regular State employees--thus the language "[i]n lieu of merit and other increment raises paid to regular State employees" precedes every statute setting up an experienced-based compensation system for judicial officials. The legislature recognizes that longevity pay for "regular State employees" is a small part of their compensation package, but it is a critical part of a judicial system compensation package that encourages its experienced decision makers to remain on the job.

Equal is not always equitable. Court officials know that--they spend their careers applying general rules to individuals, some of whom are deserving of mercy instead of equality. This recommendation would treat judicial officials equally but not equitably, given their compensation scheme and lack of job security. There is no reason to change the current system.

The Judicial Retirement System

The draft report also questions the need and cost effectiveness of the judicial retirement system. Almost every state has a retirement package for judges that is different from that for other governmental employees. They all are designed to attract and retain quality judges by taking into account the unique career pattern of judges and other judicial officials.

Most public retirement systems are predicated on the employee serving most or all of an entire career in government service. That rule, which is rational for most kinds of government service, is the last thing a state should want for its judicial officials. It should seek out as judicial officials people who have done other things, and who come to the court system as experienced, seasoned individuals to make some of the most important decisions the government can make.

Judges benefit greatly from experience in the law as advocates. District Attorneys benefit from court experiences in which they do not have the full power of the state behind them. Clerks of court make many decisions dealing with the status of persons or the value of property. Each has the substantial amount of discretion necessary to apply general rules of law to individuals. Simply put, all these officials need to know about the business of living before they begin to sit in judgment of others. As noted earlier, there is no way to fully prepare for that task. But the on-the-job training required is much more effective if these officials have experience in related fields first.

To serve that end, the North Carolina judicial retirement system is designed to make it possible for middle aged people to become judicial officials and still leave the system with a reasonable retirement. The average age for persons becoming judges is over 40. To be a judge, one must be a lawyer. The prime earning years for lawyers in private practice are their 50's and 60's. So the transition to the bench for private practitioners usually means two things-- lower initial pay and loss of the prime earning years in which to build a nest egg for retirement. The first is not always true of publicly-employed lawyers, but the state has

wisely adopted a retirement plan that makes it possible for both private and public lawyers to seek office.

The judicial retirement system compensates for that loss of the prime earning years. It allows full retirement after 24 years of service, and by allowing benefits (the percentage of final annual compensation paid to retirees) to be accumulated at rates between 3% and 4% a year, it allows adequate retirement benefits to be accumulated quickly enough for middle aged lawyers to become judges and still provide for an adequate retirement, even though the official is not able to serve the full 24 year period.

One other factor is relevant. All the officials covered by the judicial retirement system (except the Director of the Administrative Office of the Courts) are elected. One has to be an elected official to fully appreciate how insecure the position can be. The election process exists to promote accountability of key governmental officials. But the state's interest in accountability is not served well if its policies don't attract the best candidates possible. The judicial retirement system contributes to the state's ability to attract strong candidates for judicial office by making the risk of not being able to finish one's career a little less financially burdensome.

The report notes that "justifications for existing inequities need to be balanced against the State's ability to fund post-retirement benefits." It is a reasonable question to ask. But the judicial retirement system, like the experienced-based compensation system for court officials, is a carefully targeted approach to compensation that serves the important public policy of attracting and retaining the highest possible quality of judicial officials. The quality of justice is a central measure of a democracy's effectiveness. Both these features of the judicial compensation system are investments in that effectiveness. If justice matters to us as a State, we can't afford not to make these investments.